Book details valuation process

Whether you are looking to buy or sell a business, it pays to understand the valuation process. Surprisingly, the cash value of a business can vary widely according to the method of valuation employed.

Now there's a book, or rather a workbook, that walks you through all the steps.

It's called the Valuation Reference Manual and is written by Thomas J. Martin, an investment banker who specializes in financial consulting for small businesses. Publisher is Thomar Publications Inc., 383 S. Broadway, Hicksville, N.Y. 11801.

The overriding factor in determining the outcome of a valuation, according to Martin, is the motivation for having it done.

Because an appraisal of a business is always done for a specific purpose, the motives are as important as the numbers. Here are some reasons for instigating a valuation:

■ Sale of a business. A valuation can justify a high asking price by focusing attention on less obvious assets such as goodwill and patents.

Hillel Segal

■ Sale of an asset. Sometimes only part of a business is on the block — a subsidiary or division — and a valuation of just this part is needed. In this case, value that might otherwise be attributed to the corporate office needs to be allocated to the particular part.

■ Purchase of a business. From a buyer's point of view, a valuation would show just how much money is being made and whether the assets are overvalued. Also, the valuation should be structured so as to minimize taxes.

■ Expanded credit. Added values such as a company's physical plant or a patent could be made to look favorable to a lender.

■ Tax reduction. If an ownership interest is exchanged among family members, for example, a fair market value needs to be established for gift tax purposes. Also, a valuation is helpful to lessen taxes when settling an estate.

When first undertaking a valuation, it's a common mistake to think that a company's balance sheet and income statement relate to the company's actual value. More important, according to the author, is the historical picture.

One part of the historical picture is assets such as land, equipment, and buildings. They are often carried on the books at their time-of-purchase cost. As a result, their worth can exceed their depreciated cost, making them undervalued.

Another historical component is the study of past use of funds, also known as change in position. While a business has been showing profits, it may actually be losing cash. An example would be a big inventory buildup coupled with low turnover of accounts receivable. Also, overindulgence of cash resources, as in heavy plant and equipment ownership, can drain cash reserves and funds for working capital.

The book also includes a discussion of present value analysis. This is the worth today of dollars flowing in over a multiyear period, the risks in waiting to receive the money, and how much inflation will erode the value of future payments.

On the downside, the spiral-bound Valuation Reference Manual is only one of dozens of similar books on the shelves of local libraries and bookstores.

At $79 it's certainly not one of the cheapest, and while it's well written, its appearance is low-budget. There is overlapping material and no index to cross reference topics.

■ The Bottom Line. It will take some dedicated plodding to use the Valuation Reference Manual. But the examples and case histories make it worthwhile.

Hillel Segal's column includes evaluations of gadgets, seminars and books designed to enhance business productivity. Segal is a management consultant based in Boulder.